DEPARTMENT OF STATE REVENUE

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Letter of Findings: 09-0651; 09-0652; 09-0654
Individual Income Tax
For the Years 2006 and 2007

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ISSUES

I. Individual Income Tax – Imposition.

Authority: I.R.C. § 1366; I.R.C. § 1367; IC § 6-8.1-5-1; IC § 6-3-1-3.5; Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289 (Ind. Tax Ct. 2007); Selfe v. United States, 778 F.2d 769 (11th Cir. 1985); Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972); Blum v. Comm'r, 59 T.C. 436 (U.S. Tax Ct. 1972); Underwood v. Comm'r, 535 F.2d 309 (5th Cir. 1976); Leavitt v. Comm'r, 875 F.2d 420 (4th Cir. 1989); Brown v. Comm'r, 706 F.2d 755 (6th Cir. 1983); Uri v. Comm'r, 949 F.2d 371 (10th Cir. 1991); Sleiman v. Comm'r, 187 F.3d 1352 (11th Cir. 1999).

Taxpayers protest the imposition of additional income tax.

II. Tax Administration – Negligence Penalty.

Authority: IC § 6-8.1-10-2.1; 45 IAC 15-11-2.

Taxpayers protest the imposition of the negligence penalty.

STATEMENT OF FACTS

Taxpayers, three (3) shareholders ("A1," "A2," and "G"), equally and individually own one third (1/3) of an Indiana S corporation ("Corporation"), that specialized in the heating and cooling business. Corporation's gain or loss passed through to Taxpayers and Taxpayers reported the income or deducted the loss in their federal and Indiana individual income tax returns according to I.R.C. § 1366 and IC § 6-3-1-3.5.

Pursuant to an audit, the Indiana Department of Revenue ("Department") determined that Taxpayers improperly deducted the passed through losses which Corporation incurred during 2006 and 2007 tax years because each of Taxpayers did not have sufficient adjusted basis. The Department's audit, thus, disallowed Taxpayers' alleged loss deductions. As a result, Taxpayers were assessed additional income tax, interest, and negligence penalty.

Taxpayers agreed that they did not have sufficient adjusted basis for 2006, but contended that they had sufficient basis to deduct both 2006 and 2007 losses in tax year 2007. Taxpayers protested the proposed assessments. A hearing was held. This Letter of Findings ensues. Additional facts will be provided as necessary.

I. Individual Income Tax – Imposition.

DISCUSSION

The Department's audit disallowed Taxpayers' deductions regarding Corporation's 2006 and 2007 operating losses because Taxpayers did not have sufficient adjusted basis. Taxpayers, to the contrary, contended that they had sufficient adjusted basis and were entitled to deduct the losses in their 2007 individual income tax returns.

As a threshold issue, all tax assessments are prima facie evidence that the Department's claim for the unpaid tax is valid; the taxpayer bears the burden of proving that any assessment is incorrect. IC § 6-8.1-5-1(c); Lafayette Square Amoco, Inc. v. Indiana Dep't of State Revenue, 867 N.E.2d 289, 292 (Ind. Tax Ct. 2007).

Pursuant to IC § 6-3-1-3.5, the Indiana income tax rules piggyback on the federal income tax statutes and regulations. Therefore, the federal rules and case law are generally applicable to determine individual shareholder's tax liability.

I.R.C. § 1366 establishes that an S corporation's shareholders are entitled to deduct the S corporation's operating loss, passed through to them, up to the amount of their adjusted basis in corporate stock plus the adjusted basis of the corporation's debt. I.R.C. § 1366 (d) sets forth the limitations and, in relevant part, states:

(d) Special rules for losses and deductions.

(1) Cannot exceed shareholder's basis in stock and debt. The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and (2)(A) of section 1367(a) for the taxable year), and

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year).

I.R.C. § 1367 further provides:

(a) General rule.

(1) Increases in basis. The basis of each shareholder's stock in an S corporation shall be increased for any period by the sum of the following items determined with respect to that shareholder for such period:

(A) the items of income described in subparagraph (A) of section 1366(a)(1),

(B) any nonseparately computed income determined under subparagraph (B) of section 1366(a)(1), and

(C) the excess of the deductions for depletion over the basis of the property subject to depletion.

(2) Decreases in basis. The basis of each shareholder's stock in an S corporation shall be decreased for any period (but not below zero) by the sum of the following items determined with respect to the shareholder for such period:

(A) distributions by the corporation which were not includible in the income of the shareholder by reason of section 1368,

(B) the items of loss and deduction described in subparagraph (A) of section 1366(a)(1),

(C) any nonseparately computed loss determined under subparagraph (B) of section 1366(a)(1),

(D) any expense of the corporation not deductible in computing its taxable income and not properly chargeable to capital account, and

(E) the amount of the shareholder's deduction for depletion for any oil and gas property held by the S corporation to the extent such deduction does not exceed the proportionate share of the adjusted basis of such property allocated to such shareholder under section 613A(c)(11)(B).

The decrease under subparagraph (B) by reason of a charitable contribution (as defined in section 170(c)) of property shall be the amount equal to the shareholder's pro rata share of the adjusted basis of such property. The preceding sentence shall not apply to contributions made in taxable years beginning after December 31, 2009.

(b) Special rules.

(1) Income items. An amount which is required to be included in the gross income of a shareholder and shown on his return shall be taken into account under subparagraph (A) or (B) of subsection (a)(1) only to the extent such amount is included in the shareholder's gross income on his return, increased or decreased by any adjustment of such amount in a redetermination of the shareholder's tax liability.

(2) Adjustments in basis of indebtedness.

(A) Reduction of basis. If for any taxable year the amounts specified in subparagraphs (B), (C), (D), and (E) of subsection (a)(2) exceed the amount which reduces the shareholder's basis to zero, such excess shall be applied to reduce (but not below zero) the shareholder's basis in any indebtedness of the S corporation to the shareholder.

(B) Restoration of basis. If for any taxable year beginning after December 31, 1982, there is a reduction under subparagraph (A) in the shareholder's basis in the indebtedness of an S corporation to a shareholder, any net increase (after the application of paragraphs (1) and (2) of subsection (a)) for any subsequent taxable year shall be applied to restore such reduction in basis before any of it may be used to increase the shareholder's basis in the stock of the S corporation.

(3) Coordination with sections 165(g) and 166(d). This section and section 1366 shall be applied before the application of sections 165(g) and 166(d) to any taxable year of the shareholder or the corporation in which the security or debt becomes worthless.

(4) Adjustments in case of inherited stock.

(A) In general. If any person acquires stock in an S corporation by reason of the death of a decedent or by bequest, devise, or inheritance, section 691 shall be applied with respect to any item of income of the S corporation in the same manner as if the decedent had held directly his pro rata share of such item.

(B) Adjustments to basis. The basis determined under section 1014 of any stock in an S corporation shall be reduced by the portion of the value of the stock which is attributable to items constituting income in respect of the decedent.

In this instance, Taxpayers maintained that, on November 30, 2007, Corporation purchased two trucks (Truck 1 and Truck 2) to be used in the business with loans obtained by Taxpayers because Corporation did not have credit worthiness to finance the purchases. Taxpayers further stated that, as shareholders, they provided personal guarantees on the loans, i.e. their individual credit worthiness, to complete the transactions and financing through the lender, GMAC.

To support their protest, in addition to Corporation and Taxpayers' 2006 and 2007 income tax returns, Taxpayers also provided additional documentation, including, but not limited to, copies of two Notes Payable to Shareholders, dated November 30, 2007, two Retail Installment Sale Contracts, dated November 30, 2007, a letter from the GM dealer's loan officer, two truck's Certificates of Title, as well as payment details on the loans.

Taxpayers asserted that GMAC primarily looked to A1, A2, and G, as the primary obligators, for repayments of the loans, so Taxpayers' guarantees of the loans increased their adjusted basis, pursuant to the holdings of Selfe v. United States, 778 F.2d 769 (11th Cir. 1985), which followed the precedents of Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972), and Blum v. Comm'r, 59 T.C. 436 (U.S. Tax Ct. 1972).

Taxpayers are mistaken. The well established court doctrine of "economic outlay" (Underwood v. Comm'r, 535 F.2d 309 (5th Cir. 1976), Leavitt v. Comm'r, 875 F.2d 420 (4th Cir. 1989), Brown v. Comm'r, 706 F.2d 755

(6th Cir. 1983), as well as Uri v. Comm'r, 949 F.2d 371 (10th Cir. 1991)) holds that I.R.C. § 1366(d) requires an "economic outlay" by a shareholder on behalf of an S corporation before the shareholder's basis in stock or debt can increase. Only when the shareholder is required to make payments pursuant to his or her guarantee of the S corporation's debt, does it constitute an economic outlay by the shareholder. The shareholder's personal guarantees of loans alone do not increase his or her basis. Selfe, however, provides an exception to the general rule mentioned above.

Similar to Taxpayers' situation and arguments, in Sleiman v. Comm'r, 187 F.3d 1352 (11th Cir. 1999), the Sleiman brothers, the shareholder-taxpayers, referred to the holding of Selfe and believed that they were entitled to deduct the pass-through losses on their individual income tax returns because they personally guaranteed loans for the S corporations (Real Estate Equities, Inc. and Triple Net Equities, Inc.). Id. at 1354-56. However, the court ruled in favor of the Commissioner pursuant to the "economic outlay" doctrine. The Sleiman court noted that the S corporations provided valuable collateral for the loans, such as the lands as well as the improvements, and the S corporations repaid the loans regularly according to the terms of the agreements. Id. at 1358. Additionally, the Sleiman court found that the Sleiman brothers never pledged any of their personal assets to secure the loans and were only a viable secondary repayment source. Id. The Sleiman court further observed that the Sleiman brothers were never called upon to make an actual economic transfer for the benefit of the corporations under the guarantees because the S corporations made all the payments. Id. The Sleiman court thus concluded that the Sleiman brothers' personal guarantees could not increase their adjusted bases and the Sleiman brothers could not deduct the pass-through losses.

Specifically, the same Eleventh Circuit Court, in Sleiman, acknowledged its earlier Selfe decision and directly pointed out the exceptional circumstances provided by Selfe:

> In Selfe, the taxpayer established a line of credit for her retail clothing business in her own name, secured by stock that she and her family owned. Soon afterwards, she incorporated the business as an S corporation. At the bank's request, she converted her personal loans to corporate loans; she executed a personal guarantee, however, and the bank retained its security interest in the pledged stock. Although the corporation consistently operated at a loss, it never defaulted on the loan and Selfe never personally paid off any of the loan. Selfe, who wished to recognize the corporation's entire loss on her personal tax return, contended that the Commissioner should have treated the transaction as a loan from bank to her, followed by a capital contribution by her to the S corporation, resulting in an increase in her adjusted basis. Id. at 1356-57. (citation omitted).

The Sleiman court noted that the Selfe court, while acknowledging the generally required "economic outlay" to increase a shareholder's adjusted basis, concluded that "where the nature of a taxpayer's interest in a corporation is in issue, courts may look beyond the form of the interest and investigate the substance of the transaction." Id. at 1357. The Sleiman court further noted that the court in Selfe, citing Plantation Patterns, Inc. v. Comm'r, 462 F.2d 712 (5th Cir. 1972), "held that a shareholder's guarantee of a loan to an S corporation 'may be treated for tax purposes as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor'" because "the facts demonstrate that, in substance, the shareholder has borrowed funds and subsequently advanced them to her corporation." Id. The Sleiman court clearly summarized the applicability of the Selfe exception to the "economic outlay" doctrine.

Unlike the taxpayer in Selfe, in this instance, Taxpayers did not establish the alleged loans in their own names, secured by stock that Taxpayers owned. Nor did Taxpayers, at GMAC's request, convert their personal loans to corporate loans. Taxpayers' documentation showed that Corporation (Buyer/Borrower) purchased both trucks on November 30, 2007, and obtained both Certificates of Title (Owner) on December 27, 2007. Taxpayers' documentation also demonstrated that GMAC imposed liens on both trucks, which serve as valuable collateral, and Corporation directly repaid GMAC for the loans monthly as a result under the agreements.

Taxpayers' documentation did not show that they pledged any of their assets in order to guarantee the repayment of the alleged loans. Nor were Taxpayers called to repay the loans. Taxpayers' documentation showed, at best, A1 and G offered their credit worthiness (credit history) to GMAC, and GMAC used their credit worthiness to evaluate the risk of making the car loans. Unlike the S corporation in Selfe that incurred losses but never defaulted on the loan since its incorporation, here, Corporation was in business before the alleged shareholders' loans and was profitable in general since its incorporation. Only when Taxpayers expanded the business operation in 2006 and 2007, did Corporation incur losses.

Taxpayers argued that they secured the loans by using their credit worthiness and, in turn, loaned the money to Corporation to purchase the trucks. Taxpayers referred to the Notes Payable to Shareholders and the letter from GM dealer's loan officer. However, Taxpayers' documentation demonstrated otherwise. Taxpayers' documentation showed that Corporation was primary Buyer/Borrower/Owner of both trucks and GMAC was the sole lien holder of both trucks. Additionally, Taxpayers' documentation showed that A1 was Co-Buyer/Co-Borrower/Additional Owner of Truck 1 and G was Co-Buyer/Co-Borrower/Additional Owner of Truck 2. A2 was not listed, nor did A2 sign any legal documents, including the executed Retail Installment Sale Contracts and the Certificates of Title issued by the Indiana Bureau of Motor Vehicles. While A1, A2, and G signed the Notes Payable to Shareholders, neither GMAC nor Corporation signed the Notes Payable to

Shareholders. The content of the Notes Payable to Shareholders directly contradicted the executed Retail Installment Sale Contracts and the truck's Certificates of Title.

The loan officer's letter stated that "Corporation was listed as a co-borrower only for insurance and titling purposes. In the event of default, GMAC would be looking to the credit worthiness of the individuals listed on the notes for satisfaction of the terms of the notes." Aside from the fact that the statement directly contradicted the legally executed Retail Installment Sale Contracts, it also raised the question of whether GMAC could legally enforce the Notes Payable to Shareholders in the event of default because neither GMAC nor Corporation signed the Notes Payable to Shareholders. In the event of default, GMAC most likely repossesses the trucks based on the liens and begins its collection pursuant to the legally executed Retail Installment Sale Contracts, which were signed by GMAC, Corporation, A1, and G.

In short, Taxpayers' documentation demonstrated that Corporation was the primary Buyer/Borrower/Owner of both Truck 1 and Truck 2 subject to the liens imposed by GMAC. Corporation consistently and continuously paid GMAC according to the terms of the legally executed Retail Installment Sale Contacts. Although A1 and G were listed and signed as Co-Buyer/Co-Borrower/Additional Owner, they did not pledge any of their assets to guarantee the loans nor did they pay anything out of their own fund to acquire the ownership of the trucks. As the Department's audit noted that "[t]he way that the purchase of the vehicles was handled clearly dismissed any notion that [Taxpayers] ever had any loan basis in [Corporation] due to the fact that [Corporation] was the buyer of the trucks and that the payment for the loans were paid by [Corporation]."

Given the totality of the circumstances, in the absence of other documentation, Taxpayers failed to demonstrate that they made an actual economic transfer for the benefit of Corporation pursuant to the "economic outlay" doctrine. Since Taxpayers failed to meet their burden of proof demonstrating that the Department's assessment was not correct, Taxpayers' protest is respectfully denied.

FINDING

Taxpayers' protest on the imposition of additional income tax is respectfully denied.

II. Tax Administration – Negligence Penalty.

DISCUSSION

Taxpayers also protest the imposition of the negligence penalty.

Pursuant to IC § 6-8.1-10-2.1, the Department may assess a ten (10) percent negligence penalty if the taxpayer:

(1) fails to file a tax return;

(2) fails to pay the full amount of tax shown on the tax return;

(3) fails to remit in a timely manner the tax held in trust for Indiana (e.g., a sales tax); or

(4) fails to pay a tax deficiency determined by the Department to be owed by a taxpayer.

45 IAC 15-11-2(b) further states:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

The Department may waive a negligence penalty as provided in 45 IAC 15-11-2(c), in part, as follows:

The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:

(1) the nature of the tax involved;

(2) judicial precedents set by Indiana courts;

(3) judicial precedents established in jurisdictions outside Indiana;

(4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;

(5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.

Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

Taxpayers did not provide documentation to establish that their failure to pay tax timely was due to reasonable cause and not due to negligence.

FINDING

Taxpayers' protest on the negligence penalty is respectfully denied.

SUMMARY

For the reasons discussed above, Taxpayers' protest on the imposition of additional income tax is respectfully denied. Taxpayers' protest on the negligence penalty is also respectfully denied.

Posted: 06/23/2010 by Legislative Services Agency
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